



HOSPITAL MORTGAGE INSURANCE PROGRAM

SECTION 242 OF THE NATIONAL HOUSING ACT

A HUD HANDBOOK

For Program Participants and HUD Staff

FEBRUARY 2014

Federal Housing Administration
U. S. Department of Housing and Urban Development
Washington, DC 20410

FORWARD

Section 242 of the National Housing Act provides mortgage insurance for acute care hospital facilities ranging from large teaching institutions to small rural critical access hospitals. HUD provides this mortgage insurance to private lenders to ensure that adequate mortgage capital is available for needed hospital facilities.

This handbook supplements the Section 242 authorization (12 USC 1715-z7) and its implementing regulations (24 CFR Part 242). It provides detailed guidance for lenders and hospitals participating in the hospital mortgage insurance program, as well as for HUD staff and other interested parties.

Unlike many regulations, the current Section 242 – Mortgage Insurance for Hospitals regulations present program policies and procedures in considerable detail. For that reason, this handbook is organized so that it parallels and supplements the regulations, rather than duplicating their content. To understand the workings of the Section 242 program, the reader should be familiar with the regulations and also with the additional detail and guidance provided as handbook material.

For the reader's convenience, the electronic version of this handbook contains links to the regulations as published by the Government Printing Office. Each item in the handbook that supplements a section of the regulations is linked to that section. To view the regulation, the reader should click on the hyperlinks embedded throughout this document. For example, when viewing the handbook item "[Handbook guidance related to § 242.14 Mortgage reserve fund](#)," if the reader clicks on [§ 242.14 Mortgage reserve fund](#), the text of Section 242.14 of the regulations will appear in a web browser window.

The information collection requirements contained in this document have been approved by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520) and assigned OMB control number 2502-0602. In accordance with the Paperwork Reduction Act, HUD may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection displays a currently valid OMB control number.

Contents within asterisks have been changed in 4165.1 REV-1, CHG-1, 2/7/14

TABLE OF CONTENTS

LIST OF FORMS	1
HANDBOOK GUIDANCE RELATED TO:	
<u>SUBPART A—GENERAL ELIGIBILITY REQUIREMENTS</u>	2
<u>§ 242.1 Definitions.</u>	2
<u>§ 242.5 Eligible mortgagees/lenders.</u>	4
<u>§ 242.7 Maximum mortgage amounts.</u>	4
<u>§ 242.9 Physician ownership.</u>	4
<u>§ 242.14 Mortgage reserve fund (MRF).</u>	5
<u>§ 242.15 Limitation on refinancing existing indebtedness.</u>	6
<u>SUBPART B—APPLICATION PROCEDURES AND COMMITMENTS</u>	7
<u>§ 242.16 Applications.</u>	7
<u>§ 242.16(a)(1) Market Need.</u>	7
<u>§ 242.16(a)(2) Operating Margin and Debt Service Coverage Ratio.</u>	7
<u>§ 242.16(a)(3) Threshold requirements.</u>	7
<u>§ 242.16(b) Application contents.</u>	8
<u>§ 242.16(f) Application review.</u>	9
<u>§ 242.17 Commitments.</u>	9
<u>§ 242.22 Maximum fees and charges by mortgagee.</u>	9
<u>§ 242.23 Maximum mortgage amounts and cash equity requirements.</u>	10
<u>§ 242.24 Initial operating costs.</u>	12

<u>SUBPART C—MORTGAGE REQUIREMENTS</u>	13
<u>§ 242.27 Maturity.</u>	13
<u>§ 242.29 Payment requirements.</u>	13
<u>§ 242.33 Covenant for malpractice, fire, and other hazard insurance.</u>	13
<u>§ 242.35 Mortgage lien certifications.</u>	13
<u>SUBPART D—ENDORSEMENT FOR INSURANCE (RESERVED)</u>	13
<u>SUBPART E—CONSTRUCTION</u>	14
<u>§ 242.45 Early commencement of work.</u>	14
<u>§ 242.46 Insured advances—building loan agreement.</u>	14
<u>§ 242.52 Construction contracts.</u>	15
<u>SUBPART F—NONDISCRIMINATION AND WAGE RATES</u>	16
<u>§ 242.54 Nondiscrimination.</u>	16
<u>§ 242.55 Labor Standards.</u>	16
<u>SUBPART G—REGULATORY AGREEMENT, ACCOUNTING AND REPORTING, AND FINANCIAL REQUIREMENTS</u>	17
<u>§ 242.58 Books, accounts, and financial statements.</u>	17
<u>§ 242.61 Management.</u>	17
<u>SUBPART H—MISCELLANEOUS REQUIREMENTS</u>	18
<u>§ 242.72 Leasing of hospital.</u>	18
<u>§ 242.75 Title Requirements.</u>	18
<u>§ 242.77 Liens.</u>	18
<u>§ 242.89 Supplemental loans</u>	18
<u>§ 242.91 Eligibility of refinancing transactions</u>	19

APPENDICES

APPENDIX 1	ADJUSTED PATIENT DAYS CALCULATION
APPENDIX 2	MORTGAGEABLE AND NON- MORTGAGEABLE COSTS
APPENDIX 3	APPLICANT’S GUIDE – PRE-APPLICATION
APPENDIX 4	APPLICANT’S GUIDE
APPENDIX 5	APPLICANT’S GUIDE – CRITICAL ACCESS HOSPITALS
APPENDIX 6	SECTION 223(A)(7) REFINANCING
APPENDIX 7	INSURANCE REQUIREMENTS
APPENDIX 8	CONSTRUCTION GUIDE
APPENDIX 9	FINANCIAL STATEMENT PRESENTATION

LIST OF FORMS

HUD-2	Request for Waiver of Housing Directive
HUD-2205A	Mortgagor's Cert
HUD-2434	Mortgagee's Cert
HUD-2466-GP	GP Reg Agreement
HUD-41901	Assurance of Compliance
HUD-92421	MRF Agreement
HUD-92422	Fin and Stat Data Rpt
HUD-92451	Financial Record of Mortgage Loan Transaction
HUD 92453	Commitment to Insure Upon Completion
HUD 92010	Equal Employment Opportunity Certification
HUD 92330A	Contractor's Certificate of Actual Cost
HUD-92403.1	Mortgagor's And Architect's Certificate of Payment
HUD-92403	Application for Insurance of Advance of Mortgage Proceeds
HUD-92432	Commitment for Insurance of Advances
HUD 92450-CA	Completion Assurance Agreement
HUD-92452	Performance Bond-Dual Obligee
HUD-92464	Request for Approval of Advance of Escrow Funds
HUD-92466	Regulatory Agreement
HUD-2576-HF	Certificate for Need for Health Facility and Assurance of Enforcement of State
HUD 92580	Maximum Insurable Mortgage
HUD-3305	Agreement and Certification
HUD-4128	Environmental Assessment and Compliance Findings
HUD 9250	Funds Authorizations for use of Reserve for Replacement or Residual Receipts
HUD-91725	Opinion by Counsel to the Mortgagor (FHA)
HUD 92013-OHP	Application for Hospital Project Mortgage Insurance
HUD-92023	Request For Final Endorsement of Credit Instrument
HUD 92330	Mortgagor's Certificate of Actual Cost
HUD-92415	Request For Permission To Commence Construction Prior To Initial Endorsement For Mortgage Insurance
HUD-92441	Building Loan Agreement
HUD-92447	Property Insurance Requirements
HUD-92248	Contractor's Requisition
HUD-92452A	Payment Bond
HUD-92457	Surveyor's Report
HUD-92476.1	Escrow Agreement
HUD-2530	Previous Part. Form
242.35, Mortgage lien certifications	(Information is provided to HUD in a letter, not a form)

SUBPART A—GENERAL ELIGIBILITY REQUIREMENTS

Handbook guidance related to § 242.1 Definitions.

1. Terms defined in Section 242.1 have the same meaning in this handbook.
2. Handbook guidance related to the definition of *Hospital*.

Section 242.1 defines *Hospital*, in part, as a facility:

(2) Where not more than 50 percent of the total patient days during any year are customarily assignable to the categories of chronic convalescent and rest, drug and alcoholic, epileptic, mentally deficient, mental, nervous and mental, and tuberculosis, except that the 50 percent patient day restriction does not apply to Critical Access Hospitals (hospitals designated as such under the Medicare Rural Hospital Flexibility Program) between January 28, 2008 and July 31, 2011.

Because much patient care that hospitals once provided on an inpatient basis is now provided as outpatient hospital care, some acute care hospitals that also provide skilled nursing, psychiatric, or rehabilitative care have found themselves ineligible for the Section 242 program when only inpatient days were used to determine if this definition was met. Because exclusion of acute care hospitals was not intended by the statute, and in recognition of changes in the practice of medicine that have occurred over the years, HUD allows the use of an adjusted patient day calculation that takes into account the acute care provided on an outpatient basis. Refer to **APPENDIX 1** for the recommended methodology for calculating adjusted patient days.

3. Handbook guidance related to the definition of *Mortgagee*.

Section 242.1 defines *Mortgagee* as *the applicant for insurance or the original lender under a mortgage*. Although this is the way *mortgagee* is used in most cases, the full definition in the statute is:

...the original lender under a mortgage, and its successors and assigns, and includes the holders of credit instruments issued under a trust mortgage or deed of trust pursuant to which such holders act by and through a trustee therein named.

The full definition becomes important because Ginnie Mae can become a mortgagee if it extinguishes an issuer's interest in the mortgage(s) backing a Ginnie Mae security.

4. Handbook guidance related to the definitions of *Operating revenue* and *Non-operating revenue*.

HUD evaluates the source, reliability, and consistency of revenue sources when determining whether a particular source of revenue is *operating revenue* or *non-operating revenue*. If a

source of revenue has been reliably received and is expected to be received in the future, or if the revenue source was accompanied by a corresponding operating expense recorded on the income statement, that source of revenue is generally considered operating.

If the hospital is the recipient of revenue support (tax revenues, revenues from state-wide hospital assessments, or appropriations), HUD evaluates the history, nature, and authority for the support to make the determination. If the support was reliably received, and in HUD's judgment will likely continue to be received for the length of the proposed mortgage term, the support will be considered operating revenue. A strong indication that the support will continue to be received includes the presence of legal barriers that prevent revocation of the support.

In unusual circumstances, HUD may determine that revenue from grants, contributions, or affiliate relationships may be considered operating revenue. Demonstration that the revenue has been reliably received and will continue to be received is also necessary for HUD to make this determination.

5. Terms not found in Section 242.1 are defined below:

Facility means a hospital or hospitals owned by a single entity and located on a single site or multiple sites within one local community (as determined by the Secretary), Core Based Statistical Area (CBSA)¹, or State.

Fixed Equipment refers to any major equipment fixed to the building structure or any integral part of the building structure.

Moveable Equipment means moveable major items not fixed to the building structure.

Not-for-profit Facility means a facility which is owned and operated by one or more not-for-profit corporations or associations, or foundations, no part of the net earnings of which inures, or may lawfully inure, to the benefit of any private shareholder or individual.

Proprietary Facility means a facility which is owned and operated by a corporation, partnership, trust, or individual or any other qualified legal entity which is not a not-for-profit corporation or a governmental entity.

Site means the tract or plot of land on which the facility is or will be located and which is defined in the approved application.

Special Tax Assessment means a charge that a unit of government assesses against a real estate owner for certain public projects that provide a benefit to the owner. Examples are installation of water and sewer lines and streets.

¹ A Core Based Statistical Area is a U.S. geographic area defined by the Office of Management and Budget based around an urban center of at least 10,000 people and adjacent areas that are socioeconomically tied to the urban center by commuting.

Sponsor means the organization or entity that initiates and promotes the development of the facility. The sponsor may qualify as the mortgagor, or it may set up a separate entity for the purpose of qualifying as a mortgagor.

Total Estimated Project Cost means the sum of the estimated hard costs and the soft costs that are normally allowable in a Section 242 loan.

Total Estimated Replacement Cost means the total of (a) the Total Estimated Project Cost, (b) the fair market value of existing land and the replacement cost of existing improvements thereon, and (c) the fair market value of land and the replacement cost of improvements thereon of property to be acquired.

Handbook guidance related to § 242.5 Eligible mortgagees/lenders.

As part of an application for Section 242 mortgage insurance, lenders must certify that:

1. They are an FHA Multifamily approved lender; and
2. At least one member of the financing team has submitted a successful Section 242 application in the past OR at least one member of the financing team has completed FHA-provided Section 242 lender training OR the lender has at least one member of the financing team that has viewed, in its entirety, the training videos and materials available on the Section 242 program's website.

Handbook guidance related to § 242.7 Maximum mortgage amounts.

See also §242.15 and §242.23.

Handbook guidance related to § 242.9 Physician ownership.

1. Any application for Section 242 mortgage insurance which includes any physician-controlled organization to own, operate, or control a hospital will be considered as incomplete unless it includes an advisory legal opinion from outside counsel acceptable to HUD. The counsel rendering the opinion should be experienced in rendering opinions on Section 1128B [42 U.S.C. 1320a-7b] (the Anti-Kickback Statute), Section 1877 [42 U.S.C. 1395nn] (the Federal Physician Self-Referral Prohibition Act, commonly referred to as the "Stark Act"), and 42 CFR Part 1001 (Program Integrity – Medicare and State Healthcare Programs). The opinion should be submitted at the preliminary review phase and should state that the project will be in compliance with the Anti-Kickback Statute and the Federal Physician Self-Referral Prohibition Act.
2. At any time during the application or pre-application review process, the HUD Account Executive may require that the Applicant also obtain an Advisory Opinion from the Office of

Inspector General, Department of Health and Human Services, indicating approval of the proposed organizational structure.

Handbook guidance related to § 242.14 Mortgage reserve fund (MRF).

1. Holder. The MRF shall be held by the mortgagee of record or by a trustee that is acceptable to the mortgagee and HUD.
2. Contributions. Mortgagors are required to make contributions to the MRF on a quarterly basis, unless the mortgagor receives cost-based reimbursement, in which case monthly contributions are required.
3. Mortgage Reserve Fund Agreement and Schedule. Included in Supplement 13 of **APPENDIX 4** (Applicant's Guide) and **APPENDIX 5** (Applicant's Guide for Critical Access Hospitals).
4. Section 242/223(a)(7) loans. A reduction in the monthly payments as a result of a Section 223(a)(7) refinancing or other causes shall not cause a distribution of already held fund balances from the existing MRF. If the MRF is not funded at the full two years of debt service level based on the new debt service payment schedule at endorsement of the Section 223(a)(7) loan, then future funding shall be based so as to result in one full year of funding based on the new payment schedule five years from commencement of amortization of the original note and two full years of debt service based on the new payment schedule ten years from commencement of amortization of the original note according to a schedule established by HUD, unless HUD determines that a different schedule of contributions is appropriate based on the mortgagor's risk profile, reimbursement structure, or other characteristics.
5. Pre-funding. Based on the mortgagor's risk profile, reimbursement structure, or other characteristics, HUD may require that the mortgagor pre-fund a portion of the mortgage reserve fund as a condition for issuance of a mortgage insurance commitment. When considering this option, HUD will weigh the mortgagor's ability to pre-fund the MRF (measured by its unrestricted cash balance and projected cash flows) against other risk factors that impact the mortgagor's ability to achieve the revenue and volume projections necessary to meet future debt service payments.
6. Equipment Replacement Reserve Fund for Proprietary Facilities
 - a. The Mortgagor shall establish an Equipment Replacement Reserve Fund (ERRF) as a trust fund with the Mortgagee or a banking institution acceptable to HUD.
 - b. The Mortgagor shall pay into the fund ten percent per annum of the equipment included in the Total Replacement Cost as listed on FHA-Form 2264-HOSP (Maximum Insurable Mortgage). The ten percent per annum amount will be adjusted at final endorsement based upon the actual value of the equipment included in the insured loan.

- c. Funds may be drawn out of the ERRF for the purchase of fixed and/or major moveable equipment for the insured project and/or to make payments on equipment financed by capital leases, loans, or installment purchase contracts.
- d. In the event of a default in the terms of the Mortgage, or in order to avoid a default, HUD may apply or authorize the application of the balance in the ERRF as a recovery against insurance benefits paid by HUD or to apply for any other purposes which HUD may determine necessary to reduce its insurance liabilities as insurer of the Note and the Mortgage.
- e. Unless notified by HUD that HUD approval is required, Mortgagor may withdraw funds for the purchase of fixed and/or major moveable equipment upon submission to HUD of appropriate supporting documentation evidencing the purchase of equipment. Such documentation shall be verified as part of the annual audit.

Handbook guidance related to § 242.15 Limitation on refinancing existing indebtedness.

- 1. For Section 242 loans, no more than 50 percent of the hard costs may be for equipment and furnishings. However, this restriction does not apply to loans insured under Section 241, Section 242 pursuant to Section 223(f), or Section 242 pursuant to Section 223(a)(7).
- 2. If existing indebtedness to be refinanced is integrated with an interest rate swap, the cost of terminating that swap may be a mortgageable use of mortgage proceeds, within the limitations found in **APPENDIX 2**.

SUBPART B—APPLICATION PROCEDURES AND COMMITMENTS

Handbook guidance related to § 242.16 Applications.

See:

APPENDIX 3 – APPLICANT’S GUIDE – PRE-APPLICATION

APPENDIX 4 – APPLICANT’S GUIDE

APPENDIX 5 – APPLICANT’S GUIDE – CRITICAL ACCESS HOSPITALS

Handbook guidance related to § 242.16(a)(1) Market Need.

Proposals to insure start-up hospitals must demonstrate a market need for the facility during the Preliminary Review as described in 24 CFR 242.16(a)(4) using the factors described in § 242.16(a)(1)(ii). HUD performs an independent review of market need based upon the information submitted by the lender, demographic projections in the Service Area (as defined in 24 C.F.R. 242.1), and competing hospital utilization and capacity. Without a determination of market need by HUD, an application will not be approved. Section 242 mortgage insurance will support start-up hospitals only if HUD determines that the Lender has provided a compelling justification that the market area is underserved by existing hospitals, the new facility will correct this deficiency, and the proposed hospital will possess the financial and other resources necessary to meet debt service payments on the proposed mortgage.

Handbook guidance related to § 242.16(a)(2) Operating Margin and Debt Service Coverage Ratio.

Regarding **§ 242.16(a)(2)(ii)**: In cases of refinancing at a lower interest rate, HUD may authorize the use of the projected debt service requirement in lieu of the historical debt service in calculating not only the debt service coverage ratios for each of the prior 3 years, as provided in the rule, but also in calculating the operating margins for each of the prior 3 years.

Handbook guidance related to § 242.16(a)(3) Threshold requirements.

1. Regarding **§ 242.16(a)(3)(iv)**: The applicant’s response to the Applicant Data Request (described in **APPENDIX 3**) should provide sufficient information about the level of service the hospital provides to its Service Area as defined in 24 CFR § 242.1 to enable HUD to reach a conclusion, in which case no further analysis will be required of the applicant. However, in some cases, following its review of the response to the Applicant Data Request, HUD may request additional, service-specific information in order to reach a conclusion.

2. Regarding **§ 242.16(a)(3)(vi)(A)**: To meet this criterion, HUD will accept a certification from the lender that there are limited comparable affordable financing vehicles available to the hospital. The certification should be accompanied by documentation describing alternatives to the Section 242/223(f) program, and discussing why those financing options are not appropriate. This certification is required as part of a Preliminary Review submission.
3. Regarding **§ 242.16(a)(3)(vi)(B)**: To meet this requirement, HUD will accept a certification from the lender that 3 of 7 criteria in the regulation are met. This certification is required as part of a Preliminary Review submission. HUD conducts a reasonableness review of the certifications and accompanying documentation prior to issuing a Preliminary Review Letter as defined in 24 CFR 242.1. See the Section 242/223(f) Supplement in the Pre-Application Guide, **APPENDIX 3**.

Handbook guidance related to [§ 242.16\(b\) Application contents](#).

1. Regarding **§ 242.16(b)(5)** Section 242/223(f) and Section 241 applications: HUD will determine if the study is required to address market need and if there is a requirement to involve a certified public accounting (CPA) firm in the feasibility study. HUD will make these determinations based on the Preliminary Review and the Pre-application Meeting.
 - a. If HUD finds that evidence of a market need for the facility is clear and convincing, based on its analysis of the information provided in response to the Applicant Data Request and any other information obtained, no further study of market need may be required of the applicant.
 - b. HUD's decision on whether or not there is a requirement to involve a CPA firm in the financial feasibility study will be based on the degree to which the underwriting of the mortgage insurance application depends upon assumed changes in future revenues, expenses, and market share. In the case of a pure refinancing (or a refinancing including only a small component of limited rehabilitation) for a hospital that is in a stable market environment, HUD may determine that there is not a need for an opinion from a CPA firm regarding management's assumptions underlying financial projections. If the proposed limited rehabilitation (or substantial rehabilitation in the case of a Section 241 proposal) involves addition or expansion of services and/or if significant changes are projected in future revenues, expenses, or market share, HUD may determine that such an opinion is needed.
 - c. HUD's determinations will be communicated to the applicant following the Pre-application Meeting.
 - d. See **APPENDIX 6** for guidance on Section 223(a)(7) applications.

Handbook guidance related to § 242.16(f) Application review.

This paragraph provides that:

HUD shall...evaluate any other factors, including but not limited to risk to the Insurance Fund, that should be considered in determining if the application for mortgage insurance should be approved.

The review will include an examination of the hospital's relationship with, and the financial strength of, corporate parents and affiliates, and the risks that these relationships may present to the credit worthiness of the mortgage. Applicants are cautioned that one of the factors that HUD will consider in evaluating risk to the insurance fund is loan-to-replacement cost (often referred to as loan-to-value or LTV). Higher LTV ratios increase the risk of losses to the insurance fund should a claim occur.

Handbook guidance related to § 242.17 Commitments.

1. *The mortgagee is responsible for ensuring that Deposit Account Control agreements (DACA)s are in place at closing for all depository accounts that control the mortgagor's operating revenues and expenditures. (Note: DACA are not required for trust accounts such as the Mortgage Reserve Fund.) The mortgagee is also responsible for ensuring that UCC liens are filed and that all collateral for the HUD-insured loan is securitized for the life of the mortgage.*
2. Commencement of amortization is to begin no later than the 1st day of the 3rd month following project completion based on the substantial completion date in the construction contract.
3. Commitments for loans pursuant to Section 223(a)(7). **See APPENDIX 6.**

Handbook guidance related to § 242.22 Maximum fees and charges by mortgagee.

1. The mortgagee is permitted to obtain reimbursement from the mortgagor for the application, commitment and inspection fees paid to HUD. In addition, it may collect from the mortgagor an initial service charge and a permanent financing fee.
 - a. In cases that do not involve bonds, the maximum combined Initial Service Charge and Permanent Financing Fee that the mortgagee is permitted to include in the insured loan is 3.5%, consisting of:
 - (1) A maximum Initial Service Charge of 2% of the original principal amount of the Mortgage, and

- (2) A maximum Permanent Financing Fee of 1.5% of the original principal amount of the Mortgage.
 - b. In cases that involve bonds, the maximum combined Initial Service Charge and Permanent Financing Fee that the mortgagee is permitted to include in the insured loan is 5.5%, consisting of:
 - (1) A maximum Initial Service Charge of 2% of the original principal amount of the Mortgage, and
 - (2) A maximum Permanent Financing Fee of 3.5% of the original principal amount of the Mortgage.
2. Financing charges approved by HUD as reasonable, over and above those set forth in Paragraph 1 immediately above, may be collected from the mortgagor. However, any additional charges or fees collected from the mortgagor may not be included in computing the Total Estimated Replacement Cost as defined in Subpart A of this Handbook.
3. For loans insured pursuant to Section 223(a)(7), the total of the permanent financing fee plus the initial service charge may not exceed 1.5 percent in non-bond transactions, or 3.5 percent in bond transactions.

Handbook guidance related to § 242.23 Maximum mortgage amounts and cash equity requirements.

1. See **APPENDIX 2** for a listing of mortgageable and non-mortgageable costs.
2. For new construction, the mortgage shall not exceed 90% of the sum of the estimated hard costs and the soft costs that are allowable in a Section 242 loan.
3. For all Section 242 loans, the maximum mortgage amount is reduced by the amount of any loans, grants, or gifts that are intended to offset mortgage financing, and by 100% of the principal amount of any special tax assessments.
4. *Section 241 mortgage amounts, when added to the unpaid principal balance of the outstanding indebtedness relating to the property, may not exceed 90 percent of the estimated replacement cost of the property following completion of the Section 241 project.*
5. Timing of disbursement of equity contribution and advances of mortgage proceeds: See Handbook guidance related to Section 242.46 (Paragraph 3) below.
6. Calculation of “fair market value of such land and improvements.” See Sections 242.23(a)(2) Property subject to existing mortgage and (a)(3) Property to be acquired. The calculation to be used is: the fair market value of the land plus the replacement cost of improvements. See the discussion of “replacement cost” appraisals in **APPENDIX 4**,

Supplement 10. HUD may accept the net book value of plant, property, and equipment as a proxy for the fair market value of the land plus the replacement cost of improvements.

7. Leased Property

- a. The valuation for any real property and improvements that are held subject to a leasehold interest shall be reduced by 90%.
- b. If, as of Initial Endorsement as provided in 24 CFR 242.39, a parcel of land (including any improvements thereon) will be held by the Mortgagor pursuant to a ground lease, then the value of that parcel as reflected on the Hospital's financial statement (or appraisal), shall be reduced by only 5% instead of 90% if one of the following conditions applies:
 - (1) The term of the leasehold interest is equal to or greater than 99 years from the date of Initial Endorsement, or
 - (2) The term of the leasehold interest is 50 years from the date of Initial Endorsement with an option (transferable to successor organizations) to renew the lease for an additional 49 years at no additional cost in the event of:
 - (a) A monetary default on the FHA insured loan, or
 - (b) A transfer of the FHA insured loan in order to avoid a monetary default.
- c. The value of capital leases for equipment or equipment held subject to a lease shall be subtracted in its entirety.

8. *For any loan that is limited to the purchase of land and any improvements thereon, or the acquisition of a hospital, the mortgage shall not exceed the lesser of 90 percent of the actual purchase price of the land and any improvements thereon, or 90 percent of HUD's estimate of the sum of the market value of such land and the replacement cost of improvements thereon. For loans involving purchase of property or hospital acquisition that also include rehabilitation, see the regulations at 242.23(a)(3). For Section 223(f) loans involving purchase of property, also follow the regulations at 242.23(a)(3). For hospital acquisitions under Section 223(f), see the regulations at 242.23(b)(2). For Section 241 loans that include property purchase or refinancing in connection with the financing of a proposed construction project, the mortgage may include only the lesser of (a) HUD's estimate of the fair market value of such land and improvements prior to substantial rehabilitation or (b) the purchase price (or capital debt to be refinanced) as appropriate, plus other allowable costs. Valuation of land and existing improvements should follow guidance found in Appendices 4 and 5, Supplement 10 – Appraisal Preparation Guidelines. Note: Costs of purchase, acquisition, and rehabilitation are understood to include associated soft costs that are normally allowable in Section 242 loans.*

9. Definition of “cost of substantial rehabilitation.” This term, used in 242.23(a), is synonymous with “Total Estimated Project Cost”.

10. For any project that involves determining the value of existing land and improvements, HUD may require the applicant to obtain an appraisal, performed by an appraiser approved by HUD and following the guidance in **APPENDIX 4**, Supplement 10. The value determined by the appraisal may be used in calculating the maximum mortgage amount and the LTV.

Handbook guidance related to § 242.24 Initial operating costs.

1. The mortgagor shall be required to fund an Initial Operating Capital Fund adequate to cover necessary cash flows for initial operations.
2. General guidelines for the amount of initial operating capital required for a start-up hospital are:
 - a. All pre-opening expenses not yet paid;
 - b. The cost of first day supply inventories (drugs, food, surgical supplies, office supplies, etc.) and non-capital equipment (equipment that is expensed rather than being depreciated) needed to begin hospital operations;
 - c. The first six (6) months of cash expenses from the feasibility study (including project interest);
 - d. (Proprietary hospitals only) 2% of mortgage amount in lieu of AMPO.
3. Existing hospitals proposing major expansions of services may also be required to fund an Initial Operating Capital Fund. When determining whether to require funding, HUD will evaluate the mortgagor's credit profile, unrestricted cash balances, projected cash requirements of the new operations during the first six months following construction completion, and projected cash flows that the operations will generate during the same time period. In the event that HUD determines a cash flow deficit is a significant risk, an Initial Operating Capital Fund will be required.
4. *AMPO* (Allowance for Making Project Operational) as defined in 24 CFR 242.1 for not-for-profit or governmental projects is funded with mortgage proceeds and may not exceed 2% of the total construction costs per contracts. Any balance remaining unused in the fund at final endorsement will be treated in accordance with §242.43 Application for Cost Savings.
5. *AWC* (Additional Working Capital) defined herein for not-for-profit or governmental projects is a cash escrow established by the mortgagor and not funded by mortgage proceeds. It is used for the same purposes as AMPO. AWC may be substituted for all or part of AMPO. Any balance remaining unused in the AWC fund at final endorsement will be returned to the mortgagor.
6. Working Capital – Proprietary (other than start-up hospitals). A working capital deposit of 2% of the amount of the mortgage is required at initial endorsement to provide a contingency fund to protect against delay in completion of the project. It is to cover costs which may accrue due to taxes, mortgage insurance premiums, and assessments required by the mortgage during the period between initial endorsement and final endorsement of the mortgage for insurance, which costs were not included in the proceeds of the mortgage. (This deposit is required only in cases of insurance of advances. It is not required in cases of insurance upon completion.)
7. Based on its analysis of the working capital requirements, HUD may, at its sole discretion, require AMPO in excess of 2% of the total construction costs per contracts, or Proprietary Working Capital in excess of 2% of the amount of the mortgage.

SUBPART C—MORTGAGE REQUIREMENTS

Handbook guidance related to § 242.27 Maturity.

1. HUD may limit the term of the mortgage to the remaining useful life of the assets that secure the mortgage.

Handbook guidance related to § 242.29 Payment requirements.

1. Payments will be on the level annuity monthly plan. Approved terms for monthly payments, including curtail rates for reducing the principal amount of the mortgage, will be prescribed by HUD.
2. The mortgagor's monthly mortgage payments include an amount equal to one-twelfth of the annual mortgage insurance premium which the mortgagee is required to pay HUD.

Handbook guidance related to § 242.33 Covenant for malpractice, fire, and other hazard insurance.

1. The mortgagor shall maintain at all times liability, fire, hazard, boiler, and vehicle insurance of a type and amount customary in the health care industry and determined by an independent insurance consultant(s) to be adequate to protect the interests of the hospital, the mortgagee, and HUD. The fire and hazard insurance shall be for an amount that is no less than the amount of the outstanding loan and shall be acceptable to the mortgagee.
2. The mortgagor shall maintain at all times medical malpractice insurance of a type and amount that is: (1) customary in the health care industry; (2) determined by an independent insurance consultant to be adequate to protect the interests of the Hospital as defined in 24 CFR 242.1, the mortgagee, and HUD; and (3) acceptable to HUD.
3. See **APPENDIX 7** for detailed insurance requirements.

Handbook guidance related to § 242.35 Mortgage lien certifications.

HUD requires that the mortgaged property include all the assets, revenues, receipts, and receivables of the mortgagor. Proposed exclusions, and the business rationale for exclusion, should be identified during the Preliminary Review.

SUBPART D—ENDORSEMENT FOR INSURANCE (RESERVED)

SUBPART E—CONSTRUCTION

See:

APPENDIX 4 – APPLICANT’S GUIDE

APPENDIX 8 – CONSTRUCTION GUIDE

Handbook guidance related to § 242.45 Early commencement of work.

1. Regarding **§ 242.45(a)**: Site preparation work includes moving soil, preparing the site for installation of foundations, piles, slabs on grade, foundations, temporary utility installation, and other activities in preparation for construction that HUD may approve.
2. Regarding **§ 242.45(b)**:
 - a. “Structures” as referred to in paragraph (b) include major components such as buildings, new wings, additional floors, parking garages, and power plants.
 - b. Should a case arise in which exceptional circumstances create a need for an application to be submitted within two years following the completion of such structures, the potential applicant may request a waiver of the two-year requirement in paragraph (b) in conjunction with the request for a preliminary review under the provisions of Section 242.16(a)(5). HUD will review the merits of the waiver request.
 - c. Paragraph (b) refers to “structures” and not to the various minor renovations and repairs that occur from time to time at hospitals. Such minor renovations and repairs do not make an applicant ineligible for Section 242 insurance. Also, if the hospital completed them using borrowed funds prior to filing a Section 242 application, that loan could be refinanced as part of Section 242 loan, regardless of how long before application they were completed.

Handbook guidance related to § 242.46 Insured advances—building loan agreement.

1. The initial advance of mortgage proceeds may not include more than the following for lines C22, C23, and C25 on the HUD-92013:
 - a. Seventy-five percent of the Legal Expense shown on the HUD-92013, Line C22,
 - b. Sixty-five percent of the Organizational Expense shown on the HUD-92013, Line C23, and
 - c. Seventy-five percent of the Consulting Expense shown on the HUD-92013, Line C25.

2. Timing of disbursement of mortgage proceeds:
 - a. Proprietary mortgagors. Equity contributions shall be disbursed before the use of any mortgage proceeds.
 - b. Not-for-profit and governmental mortgagors. During the final 25% construction stage of a project, any remaining equity funds held in cash or investments, or in a letter of credit, shall be used prior to any further disbursement of mortgage proceeds. Also, all proceeds from grants or approved loans from sources other than the insured mortgage shall be used prior to any further disbursement of mortgage proceeds, except where the initial closing provides for a prorata disbursement arrangement.

Handbook guidance related to § 242.52 Construction contracts.

1. The requirement for competitive bidding procedures may be satisfied as follows:
 - a. Lump sum. The mortgagor obtains competitive bids from three or more sources.
 - b. Construction management. The construction manager (CM) may be selected competitively from three or more sources. Alternatively, a CM may be selected without competition, then competitively bid the subcontracts as acceptable to HUD.
 - c. Design-build. The design-builder obtains competitive bids from three or more sources. In cases where three competitive bids are not received, HUD will consider requests to waive the regulatory requirement of a competitive bidding procedure for design-build projects. In connection with such a waiver, HUD may require an independent consultant to report on the reasonableness of the cost.
 - d. Other forms of contract. HUD will review other forms of contract and associated procedures and will determine if they are acceptable.

SUBPART F—NONDISCRIMINATION AND WAGE RATES

Handbook guidance related to § 242.54 Nondiscrimination.

1. Hospital facilities financed with mortgages insured under Section 242 must be made available without discrimination as to race, color, religion, sex, age, disability, or national origin. However, the aforesaid provisions regarding age and sex discrimination do not affect the eligibility of hospitals for women and children. Hospitals must be operated in compliance with all applicable civil rights laws and regulations, including 24 CFR part 200, subpart J (Equal Employment Opportunity) and the Americans with Disabilities Act (42 U.S.C. 12101 et seq.).
2. Public accommodations, such as hospital facilities, must comply with the requirements of the Americans with Disabilities Act (ADA), including requirements for architectural standards and reasonable modifications to policies, practices, and procedures; effective communication with people with hearing, vision, or speech disabilities; and other accessibility requirements. In addition, barriers in existing buildings must be removed if it can be done without much difficulty or expense, given the public hospital's resources.
3. Further, if there is any federal funding of any kind, such as funding from HUD's CDBG program, or funding from another Federal agency, such as the U.S. Department of Health and Human Services (HHS), Title VI of the Civil Rights Act of 1964 and Section 504 of the Rehabilitation Act of 1973 apply. Section 504 contains additional accessibility and accommodation requirements for persons with disabilities. Title VI prohibits discrimination based on race, color and national origin. This further requires the provision of language services to persons who are limited English proficient (LEP) when applicable to the subject community. It is advisable to determine whether bilingual staff at all levels will be available to meet LEP patient needs as applicable to the local communities.
4. If any housing assistance is provided (e.g., dormitories for nurses), the Fair Housing Act applies. The Fair Housing Act prohibits discrimination on the basis of race color, religion, national origin, sex, disability, and familial status (i.e., children under 18 and pregnant women).

Handbook guidance related to § 242.55 Labor Standards.

See: **APPENDIX 8 – CONSTRUCTION GUIDE**

SUBPART G—REGULATORY AGREEMENT, ACCOUNTING AND REPORTING, AND FINANCIAL REQUIREMENTS

Handbook guidance related to § 242.58 Books, accounts, and financial statements.

1. Financial statements include a Balance Sheet, Statement of Operations, and Cash Flows for the mortgagor, and include the accounts and supplemental information listed in **APPENDIX 9**. Financial and statistical reports should be submitted using the template provided by HUD, which is available on OHF's website.
2. Mortgagors owning other health facilities in addition to the hospital, with a central purchasing system, may prorate expenses for materials, supplies, salaries, etc. Although no specific form of accounts is required (except for certain specified accounts), it is suggested that the Chart of Accounts for Hospitals, which is published by the American Hospital Association®, be used as a guide.

Handbook guidance related to § 242.61 Management.

Regarding **§ 242.61(a)** Contract Management:

5. The management agreement is a contract which establishes the rights and obligations between the management agent, the mortgagor and any identity-of-interest or independent fee manager. The agreement also establishes the management fee and conditions for payment of the management fee. It is the mortgagor's responsibility to ensure that the management agent performs his or her duties in accordance with the management agreement.
2. The management agreement shall state that it is subject to termination:
 - a. For failure to comply with the provisions of the management agreement or for other good cause upon written HUD request 30 days in advance. Upon such request, the mortgagor shall immediately arrange to terminate the agreement within a period of not more than 30 days and shall immediately make arrangements satisfactory to HUD for continuing proper management of the hospital.
 - b. In the event of a default under the mortgage note or regulatory agreement, immediately upon HUD's issuance of a notice of termination to the mortgagor. The agreement must also contain a clause acknowledging the following:
 - (1) HUD's and the mortgagee's rights and requirements will prevail in the event the management agent conflicts with HUD's or the mortgagee's requirements or restricts HUD's or the mortgagee's rights; and

- (2) The management agent must turn over to the owner all of the project's cash, trust accounts, investments, and records within thirty days after the date the management agreement is terminated.
- (3) HUD requires a written management agreement. The terms of the agreement shall be complete as to the extent of the agent's duties and the amount of the agent's fee.

SUBPART H—MISCELLANEOUS REQUIREMENTS

Handbook guidance related to § 242.72 Leasing of hospital.

Leasing of a not-for-profit facility to a proprietary entity will not be considered.

Handbook guidance related § 242.75 Title requirements.

Co-insurance: Where a mortgagor requests that title insurance be provided by two different title companies through co-insurance, HUD shall require that the title companies provide an endorsement to the title policy indicating that the title companies will be held jointly and severally liable.

Handbook guidance related to § 242.77 Liens.

1. The mortgagee must first give its approval to the inferior lien.
2. HUD must give its prior approval to the inferior lien, after making a determination that income will be available to make required payments on both the first and inferior liens.
3. *If secondary financing is supplied by a federal, state, or local government instrumentality for a project that will be financed with an FHA-insured loan, it should be at a lower rate than the FHA-insured mortgage.*
4. Terms of the proposed inferior lien shall be included in the application, included in the financial forecast, and will be taken into account in the underwriting when calculating ratios, cash flows, projected income, and benchmarks in accordance with HUD policies.

Handbook guidance related to § 242.89 Supplemental loans.

1. Prior to entertaining a mortgagor's application for a supplemental loan, HUD conducts a preliminary review based upon information submitted by the hospital, lender, or financial consultant representing the hospital. Hospitals with an aggregate operating margin of less

than 0.0 and a debt service coverage ratio of less than 1.25 according to the three most recent audited financial statements do not qualify for a supplemental loan.

2. Should the preliminary review identify no obvious reasons why a supplemental loan would be rejected, the lender may be invited to a pre-application meeting or invited to proceed directly to application submission.
3. Applications for supplemental loans insured pursuant to Section 241 of the National Housing Act are underwritten by HUD based on the mortgagor's credit profile. When underwriting supplemental loans, HUD carefully considers the financial feasibility of the proposal and the financial capacity of the applicant in order to avoid insurance defaults and claims for insurance benefits.
4. Hospitals with Section 242 loans are well known to HUD, having undergone underwriting followed by continual monitoring while in the insured portfolio. For this reason, the full scope of the review of an application for new Section 242 insurance may not be applicable to an application for a Section 241 supplemental loan. In particular, the requirements for a study of market need and financial feasibility (242.16(b)(5) and related Handbook guidance) may not apply to every Section 241 application. HUD will consider the scope and nature of the proposed project as well as the hospital's track record while in the portfolio in determining the extent of study required.

Handbook guidance related to [§ 242.91 Eligibility of refinancing transactions](#).

Regarding **§ 242.91(a)** Refinancing capital debt insured by FHA. See **APPENDIX 6**.

Regarding **§ 242.91(b)** Refinancing capital debt not insured by FHA:

1. For the purpose of determining the monthly debt service cost savings, HUD will exclude the monthly debt service cost on the new Section 242/223(f) insured loan attributable to any new hard costs included in the insured loan.
2. If the existing capital debt to be refinanced consists of more than one loan, the determination of debt service cost savings will take into account the weighted average of the monthly debt service payments of the loans to be refinanced.
3. Applications must include the mortgagee's certification that monthly debt service costs are lowered by the Section 242/223(f) loan. The certification [see Supplement 11 in **APPENDIX 4** (Applicant's Guide) or **APPENDIX 5** (Applicant's Guide for Critical Access Hospitals)] should be provided in the lender's application for mortgage insurance.